it's 5pm: how much did you lose today on corporate actions?

By Neil Henderson, Securities Processing & Fund Services executive, JPMorgan Investor Services

With more than a million corporate actions taking place each year — valued in billions of dollars, pounds and euros — the poor quality and bulky flow of relevant information should have market participants waving their fists and threatening to sue. But until recently, the tolerance for loss in the corporate actions arena has been puzzling.

Even more perplexing, in a financial environment driven by sophisticated technology and instant communication, is that processing corporate actions continues to be largely manual — exposing everyone in a complex chain of intermediaries to considerable risk of failure.

Unlike the tree in the koan, corporate actions spring up overnight and a failure at any point in an event is unequivocally "heard" by hundreds of fund managers, custodians, broker/dealers and depositories — due to a single, undeniable dynamic: *the moment an issuer declares an event, the price of the underlying security changes*.

Clearly, the risk of failure is not just a back office issue, but also one that affects trading strategies and corporate positioning as well as the efficiency of the broader capital markets.

This article will provide an overview of the risks in the corporate action processing chain, and offer some insights into the solutions.

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The Basics

Although there are more than a thousand types of corporate actions across international markets, for the most part they fall into the following three categories, each with its own potential for added expense, suboptimal trading decisions, and inefficient corporate governance.

- Compulsory Actions, such as cash dividend and interest payments, which require no discretionary action on the part of the investor/intermediaries;
- Compulsory Actions with Options, which, for example, may give shareholders the option to receive dividends as cash or as additional shares;
- Voluntary Actions, where an investment decision (and corresponding action) is required on the part of the investor/agents.

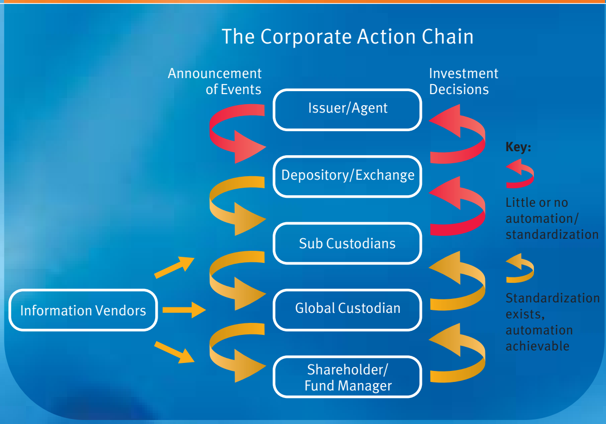
Although there is little operational risk in the first category, which requires no action, there is ample scope for failure in the second two, due to the following issues:

Confusing Notification: Issuers have a legal obligation to notify the market via prospectus and tombstone advertising; however, with no standard medium or format for making announcements, and no single securities identification system that is universally accepted, the only predictable results are confusion and uncertainty.

Multiple and Redundant Intermediaries: An entire subindustry has grown up around scrubbing and interpreting the data from issuers, their agents and supplementary information vendors, encouraging understandably risk-averse fund managers to subscribe to multiple providers. As a result they are not only paying for redundant information, but also reducing a narrow decision window.

Incompatible Timeframes: With so many intermediaries setting their own deadlines for processing, handling and communicating, the window for the ultimate decision maker is often far too narrow.

“If a tree falls in the forest and nobody hears it, does it make a sound?” Buddhist koan



Lack of Standardization: A broad range of possible responses is complicated by regulatory and market-driven restrictions, as well as the need for cross border security. Standardizing forces a discipline around the process reduces errors and time loss, with end-to-end automation of corporate actions the ultimate goal.

Error Prone Communication: Instructions for high ticket, confidential investment decisions are often sent to investment intermediaries by fax, telex or unformatted email and processed manually — providing unlimited potential for misinterpretation or mishandling.

Conflicting Agendas: At the same time that financial institutions are working for standardization and straight through processing, corporate brokers are driven to invent complex variations for staging corporate events.

Complexity: A hostile takeover attempt, for example, can change form several times, and set off uncharted corporate actions on the part of the targeted corporation. With multiple rounds of updated information traveling up and down the chain of participants, the possibilities for error are exponentially increased and the cost of failure can be significant.

A recent study on the risks of corporate action processing by DTCC and Oxera Consulting,[1] suggests that losses due to poor investment decisions may be as high as $8 billion. Clearly, the potential for error and miscommunication up and down the chain represents an unacceptable level of risk.

Working for Change

In an ideal world there would be no need to scrub corporate action data. Issuers would do their own interpretations, using industry approved standardized terms in industry standardized and machine readable formats — and the market would respond electronically, using industry approved communication channels with an end-to-end electronic audit trail. In the real world, of course, this kind of change tends to be evolutionary. The good news is the evolution is definitely in progress.

As recently as three years ago, corporate action information was still flowing via fax, mail and phone calls across 90 international markets, using varying formats, terms and standards, with manual input at every point in the chain. In the chilling words of an unhappy fund manager, “In the last year we processed more than $400 million in corporate action investments entirely by fax.”

But in 2001, at the urging of its custodian members, SWIFT launched a new and more usable suite of messages for corporate actions; providing the first real opportunity for the entire industry to send and read comprehensive and consistent corporate action information. The current challenge is to get the industry to agree on standard terms, words, formatting and key data elements. In a very real sense, it means all of us must learn a new language. As we become more fluent as an industry, the goals of standardization and straight-through processing become more reachable.

1. “Corporate Action Processing: What are the Risks?” *DTCC/Oxera 2004*

Furthermore, technology has arrived which enables issuers or their agents to announce the terms of a corporate action in a user-friendly way, and to convert to a machine readable ISO standard without the requirement for brand new software or hardware installations.
The next real challenge will be encouraging the issuers and their agents to adopt such practices, and for established national market industry groups to provide the templates and mapping tables to support them.

The Pivotal Role of the Custodian

As a major global custodian and a leader in driving change, experience has taught us that solving our customer's problems helps us to help the industry. In terms of processing corporate actions, it means far more than capturing our clients' investment decisions and passing them on to the handling agents, it means laying the groundwork for change by developing effective, long-term solutions — solutions that can be adopted by other custodians, and ultimately become standard industry practice.

In this context, it meant being the first customer to utilize the SWIFT ISO15022 industry standard, and the first to use it for sending corporate action information. Today it means being a participant in industry market practice groups, actively helping to define standards in each market for each event

The Ongoing Evolution

The next steps must come from the issuers, who have much to gain through standardization. It will force a discipline around the entire process, which will reduce errors and time loss on their end as well as free up time and money for more value added uses. Becoming part of a joint effort will improve their standing in the markets, by eliminating everyone's reliance on old-fashioned publishing formats. No one can argue that it is much faster and more efficient to send data via a SWIFT ISO15022 message, than to print mail and email thousands of prospectuses all over the world.

corporate action instructions online

JPMorgan's Corporate Action Instructions Online provides a user-friendly internet-based way to respond to corporate action information online. Corporate Action Instructions Online — accessible via JPMorgan ACCESS℠ — helps clients reduce risk and improve operational efficiency by replacing phone- and fax-based systems.

This innovative corporate action tracking tool features:

- Delivery of corporate action notifications
- Internet access using single sign on and state-of-the-art security safeguards
- Easy inquiry via "fast search" function
- Ability to overwrite/amend pre-populated instruction data
- Ability to bulk instruct/respond
- Robust online instruction audit trails
- Red/amber/green deadline management

For more information contact your relationship manager or client service officer.

In the interim, at JPMorgan we encourage our clients to automate with us, either through SWIFT or our own corporate action internet portal. In addition, we offer clients innovative messaging solutions, enabling us to convert and deliver their information on Message Express (MX) in ISO15022 format. Our corporate action system receives information from daily automated vendor feeds, major market sources, as well as our extensive sub-custodian network, enabling us to provide timely and accurate information, aggressive response deadlines, and a comprehensive online suite of investor tools to allow for online reporting and instruction execution. The resulting STP rate of 60% for voluntary action instructions is clear evidence that these goals are truly achievable. ○○○